Discussion

on

The effect of the monitoring function and advisory function on board structure *(by I. Acero Fraile and N. Alcalde Fradejas)*

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1. INTRODUCTION

The objective of the study is to analyze the internal and external factors that influence the size and composition of boards of directors. The basic premise is that each company has different needs for advice and control by the board, and that those needs are determined by the complexity of the company and the availability of alternative control mechanisms respectively. Taking into account those needs, firms choose their board size and composition. On the basis of this idea, two hypotheses, a complexity hypothesis and a monitoring hypothesis, are tested on a sample of 171 Spanish firms trading on the Stock Exchange during the 2004-2008 period.

The paper deals with the study of an interesting and topical area, determinants of boards of directors' size and composition. During the past decades, few issues have received as much attention as corporate governance and boards of directors. However, far more research is needed because we still know little about how boards actually work and how they are structured. The topic of corporate governance is of special relevance both in professional and academic settings, due to the wave of financial scandals which has shaken international markets. Inadequate corporate governance structures and, in particular, poor supervision by boards of directors have been singled out as the root cause of these corporate scandals (Dalton and Dalton, 2005). During recent years, the progressive concern for finding working corporate models has led to a large body of research to find recommendations for an optimal operational code for boards of directors, which governs the principles of listed companies, which is both transparent and efficient in its reporting to investors and shareholders in order to regain their confidence. Although the starting point of those recommendations is very heterogeneous in terms of the legal and institutional environment in each country, a common theme is an agency theory approach which seeks to strength the monitoring board role. There are common advices advocating smaller and more independent boards in the belief that they monitor better.

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The emphasis of these codes on the monitoring function of boards is aligned with the focus of agency theory in much of the literature on boards of directors. During more than two decades agency theory has been the dominant theory in studies about boards of directors. However, related empirical evidence is inconclusive and there is limited guidance for policymakers seeking to identify governance practices that result in more effective firm performance (Finegold, Hecht and Benson, 2007). Many companies are moving away from previously recommended models of governance and there is considerable heterogeneity in the structures adopted by boards. In this sense, recent research on this field points out that no single theory explains the board of directors configuration, suggesting the need to apply a multi theoretical approach and to extend the analysis beyond the traditional board role of monitoring, to consider also the advisory one (Hillman and Dalziel, 2003). With respect to this last point, we are moving towards a human capital and knowledge based economy and many of the underlying assumptions of agency theory can be considered empirically wrong when relating to knowledge based activities and resources (Huse, Hoskisson, Zattoni and Viganò, 2011). This view was advanced by Pfeffer and Salancik (1978), who identified the provision of advice and counsel and the exercise of control as two primary components of a board's internal administrative function. The paper of Acero and Alcalde is sitting within this trend and complements agency theory predictions by using resource dependence theory.

Following recent research on corporate governance, another important feature is the endogenous approach adopted in the study. This approach states that the structure of the board of directors is endogenously determined by company characteristics and the contractual environment in which it operates (Hermalin and Weisbach, 2003) and, therefore, the ideal composition for a board of a particular organization may not be the same as for another. That is to say, no single optimal structure will fit all firms. Given its own needs for advice and control, each company will choose for its board the structure which maximizes its efficiency. This idea implies that, under determined circumstances, larger and less independent boards could be better than smaller and more independent boards. As Andrés and Rodríguez (2009) point out, determining when one particular function, the monitoring or the advisory one, proves more important than the other is an important topic for research.

The context of analysis chosen in this study is also relevant. Theory and research, to a large extent, have been shaped by the situations and developments in large U.S. corporations. There has been very limited attention given to boards and governance in other settings, such as different national contexts in Europe. Consequently, much remains to be learned about boards and governance outside the samples of large U.S. corporations. The selection of Spain as the context for analysis is of relevance because of the *French Civil Law* origin of its legal system. This means that the corporate governance model is characterized by a high ownership concentration, higher than in countries whose legal systems had their origins in *Common Law*, due to the lower protection of shareholders' interests in the former (La Porta, Lopez-de-Silanes and Shleifer, 1999). Thus, the Spanish business sector enables authors to analyze board of directors structure in a context characterized by high ownership concentration, in contrast to most existing literature, which focuses on American and Anglo-Saxon markets framed out within the tradition of *Common Law.* While in the US the main issue is managers' opportunistic behaviour (agency problem owner-manager, Villalonga and Amit, 2006), in continental Europe the focus is on the divergence of interests between large and minority shareholders (agency problem owner-owner, Villalonga and Amit, 2006). The monitoring role by owners is not as important in US as in continental countries, where ownership concentration is higher, the level of investor protection is lower and large blockholders have greater power and stronger incentives to ensure shareholder value maximization (Sánchez-Ballesta and García-Meca, 2007). The institutional context in which the company operates is of special importance when determining the relevance of both main board roles, named the supervisory and advisory functions. In this sense, Andrés and Rodríguez (2009) suggest that in contexts exhibiting a greater convergence between ownership and management, the advisory board role could prove more important than the monitoring one.

The main results of the paper highlight that board composition (measured by the percentage of independent members) and size (measured by the number of board members) are established by a rational choice process which considers each firm's specific characteristics and needs for advice and supervision. Authors conclude that, in the aggregate, board size and independence are positively affected by the complexity of the decisions to be made and the need to solve possible agency problems. However, the board's two functions (advisory and control) have different specific weights when explaining each of the two characteristics considered (board size and independence). While variations in board size basically attend to different advisory requirements, variations in the proportion of independent directors are more due to the need for control. These results are interpreted by authors as a probe that in the Spanish context independents are basically intended to monitor large block holders and protect the interest of minority shareholders rather than because of their experience and advisory capacity. However, more directors (larger board size) are sitting when the complexity of the firm increases because they are in more need for advice.

In my opinion, both the topic and the theoretical and empirical approaches are relevant in the corporate governance field. After these comments on general aspects of the paper, some specific issues are exposed which authors could consider in future extensions of the present research.

2. COMMENTS ON THE SAMPLE, METHOD AND MODEL

The sample is compounded of 753 observations of 171 firms during the 2004-2008 period. Taking into account that the sample is a combination of longitudinal and cross sectional data, the econometric approach used to test the hypotheses was panel data, which allowed authors to model the unobservable heterogeneity between different companies. Specifically, authors used Feasible Generalized Least Squares (FGLS) estimators, which are robust to the presence of autocorrelation and heteroscedasticity. However, this methodology does not take into account the problem of endogeneity arising in corporate governance researches. To solve this matter, authors run an alternative regression by using the Generalized Method of Moments (GMM). In this regard, authors do not indicate whether they are using the *difference GMM estimator* or the *system GMM estimator.*

When comparing them, apart from using a greater number of moment conditions, which may be informative, the *system estimator* allows including in the model time-invariant variables, such as those relating to a board with a low temporal variability that would be eliminated in the initial model in differences. In addition, Blundell and Bond (1998) show that the *system estimator* provides less biased estimates than the estimator of the model in differences in the case of finite samples and in the case that the dependent variable is persistent, since in this model instruments appear to be weak (see Bond (2002) for a discussion of the issue).

The short period of analysis could be a limitation of the study: a five-year data period does not allow measuring the evolution of corporate boards as firms mature. Authors argue that it cannot be enlarged because the obligation for Spanish companies to present annual corporate governance reports began in 2004. However, many Spanish firms presented their corporate governance reports before that year. Taking into account the advantages of an unbalanced panel data, observations before 2004 could be included for many firms of the dataset. Nevertheless, it must be acknowledged the hard work of authors when collecting data, because the database of corporate governance variables had been made manually, firm by firm and year by year.

Another important subject with respect to the period of analysis is regarding the different codes of good governance along that period. In this sense, the Aldama Code and the Conthe Code could be influencing the size and independence of boards of directors. Corporate governance reports for the 2004-2006 subperiod are under the Aldama Code, while reports for 2007 and 2008 are under the Conthe Code. It is possible that the configuration of a board of directors is not following an efficiency criteria but pressure implemented, for example, by good governance recommendations. In keeping with this idea, it could be interesting to analyze the time trend of board size and board independence along the 2004-2008 period and to develop a framework based on institutional theory for investigating and understanding to what extent boards of directors respond to changes in the national pattern of corporate governance (Aguilera and Cuervo-Cazurra, 2004). In this respect, there is anecdotal evidence that boards have undergone substantial changes due to forces like shareholder activism and technology advancement (Link, Netter and Yang, 2008).

According to two board roles under analysis, authors develop two hypotheses to test. On the one hand, the «control hypothesis» states that «as the need for control grows, boards become smaller with a larger proportion of independent members». In this regard, authors consider that needs for control grows when there are no other alternative control mechanisms in place. As proxies for control mechanisms other than the board of directors, managerial ownership, ownership concentration, level of debt and leadership structure are used. On the other hand, the «complexity hypothesis» states that «as the need for advice grows, boards become larger with a larger proportion of independent members». Regarding this last proposition, authors consider that needs for advice grows when the firm becomes more complex. As proxies for the complexity of the firm, size of the firm, degree of diversification and firm age are used. Although both hypotheses have been adequately stated and they logically flow from theory discussion, in my view some aspects which may be of particular relevance within a context of high ownership concentration have not been considered. Their consideration could guide authors in future extensions of this research.

Firstly, in the control hypothesis development, authors do not take into account that board size reflects a *tradeoff* between the firm-specific benefits of increased monitoring and the costs of such monitoring (Boone, Field, Karpoff and Raheja, 2007). For example, Lehn, Patro and Zhao (2009) argue that high-growth firms will have small boards with a high proportion of insiders because their costs of monitoring are high. Coles, Daniel and Naveen (2008) suggest that the proportion of inside directors will be positively related to the firm's RandD expenditures because outside board members are ineffective in monitoring firms with high growth potential. Linck *et al.* (2008) argue that firms facing greater information asymmetry will have smaller and less independent boards because of the higher costs of monitoring. Raheja (2005) and Harris and Raviv (2008) suggest that the net benefits of extra monitoring increase with managers' opportunities to consume private benefits, but decrease with the cost of monitoring.

As authors indicate, one of the motivations for this study is the context of analysis, the Spanish stock market. This implies that agency conflicts are different from those of Anglo-Saxon markets. From my point of view, although authors are taking this fact into account when explaining results, they are not considering agency conflicts that may arise in a context of high ownership concentration when establishing hypothesis to be test. Much of their theory is built on research on dispersed ownership structures. In addition to the characteristic concentrated ownership, the ownership arrangement of most Spanish corporations is further complicated by pyramidal and cross-holding structures (Fernández-Rodríguez, Gómez-Ansón and Cuervo-García, 2004; Sacristán-Navarro and Gómez-Ansón, 2007). These ownership arrangements allow controlling owners to commit low equity investment while maintaining tight control of the firm, creating a separation in control (voting rights) and ownership (cash flow rights). One consequence of the divergence between voting and cash flow rights is that the controlling owner becomes entrenched with high levels of control, while the low equity ownership level provides only a low degree of alignment between the controlling owner and minority shareholders. In my opinion, controlling owner entrenchment as an agency cost of the separation of cash flow rights from voting rights should play a key role in the theoretical models on corporate governance within a context of high ownership concentration.

Regarding the advisory board role, in my view there are some aspects that could nuance arguments leading to the complexity hypothesis development. For example, authors do not take into consideration the relevant role that executive directors play for the advisory board function, due to their specific knowledge and expertise about the business (Carpenter and Westphal, 2001; Raheja, 2005). Recommendations to recruiting an effective board of directors have been focused mainly on director independence at the expense of other skills and qualifications. However, the financial crisis has shown that the tremendous complexity of the businesses and risks facing financial institutions warranted more industry expertise and insider knowledge in their boards. While independence and expertise are not always mutually exclusive, independence thresholds do preclude the candidacy of insiders with extensive day-to-day knowledge of the company and tend to also preclude individuals who, in conjunction with their development of industry expertise, have naturally developed relationships and affiliations in the sector (Lipton, Rosenblum and Cain, 2011).

In the discussion of separating the titles of the CEO and chairperson, authors have ignored agency cost of controlling the behaviour of a non-CEO chairperson (Brickley, Coles and Jarrell, 1997). Moreover, the CEO has expertise and specialized knowledge about the business valuable to the chairperson's job in his/her advisory board role. Then, separating the CEO and the chairperson titles necessitates the costly and generally incomplete transfer of critical information between the CEO and the chairperson. As Adams and Ferreira (2007) suggest, if the CEO is also the chairperson of the board he/she will make his/her knowledge available to directors, allowing them to play their advisory role more effectively. According to these ideas, leadership structure is not only influencing needs for control by the board, as authors have considered, but also needs for advice (Brickley *et al.* 1997; Hillman and Dalziel, 2003). Both monitoring and advising by the board are more effective when the board is better informed. Since many independent board members have full-time jobs in other corporations, they rely on the CEO to provide them with relevant firm-specific information. The better the information the CEO provides the better are the board's advice and supervision. However, the CEO faces a trade-off in sharing information. On the one hand, the board will give better advice if the CEO shares his information. On the other hand, information revealed by the CEO helps the board to determine the range of options available to the firm. The more precise the board's information about these options the greater the risk to the CEO that the board will interfere in decision making. Consistent with the quote above, the two roles of the board may conflict. In keeping with this idea, Adams and Ferreira (2007) show that in selecting their boards shareholders may choose to play off one role against the other. Specifically, to encourage the CEO to share information, shareholders may optimally elect a less independent or friendlier board that does not monitor the CEO too intensively.

Finally, in addition to explanatory variables, authors have included control variables in all estimated models to avoid any bias in the results. They have included dummy variables to monitor for industry level factors, such as economies of scale and competitive intensity that may account for variation in board size and board independence across industries. The rationale for industry fixed effects is that they control for the underlying economic environment that might jointly determine board size and independence. Firms in the same industry face similar production technologies and market conditions, the very things that give raise to the endogeneity problem in the first place. Moreover, authors control for time effects to take into account macroeconomic matters. However, in the light shed by previous literature, it is also important to control for business economic results or for market valuation when estimating board size and board independence determinants. It significance in previous studies shows that boards adapt their structure depending on those variables in the lag period. For example, Boone *et al.* (2007) show that firms respond to poor operating performance by increasing the proportion of outsiders on the board.

3. COMMENTS ON THE RESULTS AND IMPLICATIONS

The results evidence the importance of taking into account the problem of endogeneity arising in studies of corporate governance. Findings without controlling for endogeneity (FGLS) show that most of the relationships are significant, in contrast with results considering the endogeneity of governance variables (GMM). Therefore, readers should be cautious when interpreting results of tables 7 and 9 of the paper. A summarize of hypothesis and results can be observed in table 1 of this discussion.

TABLE 1

Summarize of hypotheses and results

Hypotheses	Board size	Board independence	Variables (Proxies)	Board size			Board independence		
				Expected	FGLS	GMM	Expected	FGLS	GMM
Control	+	-	Executive ownership	+	-	NS	-	NS	NS
			Ownership concentration	+	-	-	-	-	-
			Debt	+	NS	NS	-	-	-
			Leadership	+	+	NS	-	-	NS
Complexity	+	+	Firm size	+	+	+	+	+	+
			Diversification	+	+	-	+	+	NS
			Firm age	?	NS	NS	?	-	-

Note: + indicates a positive influence of the proxy variable on the independent variable.
- indicates a negative influence of the proxy variable on the independent variable.
? indicates an unknown expected influence of the proxy variable on the independent variable.
NS indicates a non significant influence of the proxy variable on the independent variable.

In my opinion, reliable conclusions can only be established by taking into account the endogeneous nature of the variables under consideration. In this sense, results controlling for problems of endogeneity (GMM) indicate that significant variables affecting board size are only ownership concentration, firm size and level of diversification. With respect to ownership concentration, the relationship with board size is negative, contrary as it was expected according to the control hypothesis. Regarding firm size, the relationship with board size is positive, consistent with the complexity hypothesis. However, the influence of diversification on board size is negative, contrary to the prediction of the complexity hypothesis. Likewise, significant variables affecting board independence are ownership concentration, the use of debt and firm age. With respect to ownership concentration and debt, the relationships with independence are negative, consistently with the hypothesis of control. On a whole, these results suggest caution in interpreting empirical evidence that purports to draw causal links between board variables and firm characteristics when board variables are treated as exogenous. They also imply that a «one size fits all» approach to board size and composition is misguided, since a large part of the considerable variation in board size and composition is explained by variables such as firm size and ownership concentration, suggesting an underlying economic logic at work in determining board structure.

With respect to the negative relationship between ownership concentration and the proportion of independent directors, authors conclude that, as ownership concentration is another control mechanism, it has less need for the board to act in a supervisory capacity, so fewer independents are required. This conclusion could be nuance by arguments of Kim, Kitsabunnarat-Chatjuthamard and Nofsinger (2007) pointing out that within a given country, if investors become large shareholders in part so as to expropriate wealth from minority shareholders, then these large owners may use their control to appoint managers and directors that are aligned with them to facilitate the expropriation, thus explaining the negative relation between ownership concentration and board independence. Without strong laws to help and to empower minority shareholders, countries with weak minority shareholders laws may have firms with concentrated ownership although independent boards might not arise. Minority shareholders need strong legal rights to positively affect board composition and appoint more independent directors to protect them for expropriation from large shareholders. Within a country, a large owner might use his power and influence to create independent boards for delegated monitoring and, alternatively, a large owner might use his power to appoint managers and directors aligned with him.

In the last section, authors have divided the sample according to two variables that are intended to represent needs for advice and needs for board control. Authors have considered that firms are «in more need of advice» if they are more complex according to firm size. Thus, smaller firms are considered to be «in less need of advice». They have also considered that firms are «in more need of control» if they have a more diffused ownership structure. Thus, firms with a high ownership concentration are considered to be «in less need of control». On the one hand, arguments leading to needs for advice are consistent with results of previous regressions, because firm size seems to be a good proxy for firm complexity and the reported relationship between firm size and board size is positive. On the other hand, however, potential conflict of interest among large block holders and minority shareholders could nuance the relationship that authors establish between lower concentration of ownership and higher needs for control by the board. Indeed, the influence of ownership concentration on board size is negative, contrary to as it was expected according to the hypothesis established by authors. As I have previously commented when referring to the hypotheses development, although authors state that within the Spanish context main agency problem is not between owners and managers but between large and minority shareholders, they do not take into account this matter when designing the empirical analysis. Moreover, by considering not only the quantitative dimension of the ownership concentration but also its qualitative dimension, it could be easier to establish a reliable conclusion on the relationship between ownership concentration and needs for control, because not all large shareholders have the same incentives to control managerial behaviour and/or to expropriate minority investors. In keeping with above comments, the negative relationship between board size and ownership concentration could be closely related to the qualitative dimension of ownership structure (Lane, Astrachan, Keyt and McMillan, 2006).

Authors also find that board independence is more related to needs of control than to needs of advice. In the view of this result they conclude that, although independents are important for effectively performing the board's two functions, in the Spanish context they are basically intended to protect the interest of minority shareholders and, as a consequence, they are chosen as board members precisely because of their control capabilities and not because of their experience and advisory capacity. This conclusion could be nuance by arguments suggesting that in some concentrated ownership structures control by independent directors could be non optimum (Lane et al., 2006).

As a final comment on this paper, I would like to emphasize that, despite the tremendous growth in research on corporate governance and boards of directors within the fields of finance, management and organization, there are various issues that need further research. These issues are contingency perspectives and behavioural perspectives (Huse et al, 2011). Contingency studies should use fit-models showing that in some contexts certain board designs may be recommended, but in other contexts other designs may be more important. Contextual studies will also question universalistic effectiveness criteria. Values and objectives vary across contexts and actors and this also needs to be taken into account when designing and interpreting empirical studies. Moreover, behavioural insights from agency theory are very limited, and lessons from the behavioural theory of the firm may be the natural starting point for establishing better field research from a behavioural perspective on boards and governance. Future extensions of this paper could be focus on this last trend, although the availability of data often creates limitations in terms of research questions.

To finish this discussion, I would like to sincerely congratulate the authors for their hard and rigorous work on a topic that is of current interest for both academicians and practitioners, as well as for regulatory bodies. This is an interesting study, both theoretically and empirically. I really appreciate the hard work authors have put into the paper and I am delighted to read their excellent work within *Revista Española de Financiación y Contabilidad-Spanish Journal of Finance and Accounting.* The paper invites readers to challenge and develop our understanding of boards and governance. To my own knowledge, this is the first study addressing the research question of which are the determinants of the structure of board of directors within the Spanish context by taking into account two main board roles (monitoring and advising), considering the endogeneity problem arising in corporate governance research and reaching to an interesting set of conclusions.

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